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investment bulletin

Fletcher King
CHARTERED SURVEYORS

Institutional Investment in Property

In the first release of GDP covering a full quarter of data following the EU referendum, the pattern of growth continues to be broadly unaffected. A strong performance from the service sector offset falls in manufacturing, construction and agriculture.

Contrary to expectations of just 0.1% growth in Q3, October's preliminary estimate of gdp indicates that economic output increased by 0.5% in Q3 and by 2.3% in the year to September. In comparison output grew by 0.7% in Q2 and by 2.0% in the year to June 2016.

MSCI data indicates that the market suffered its third consecutive quarter of falling prices. Capital values as measured by the MSCI Monthly index fell by –3.6% in Q3 as the property market reacted to the uncertainty created by the referendum result and retail investors sought to exit their positions in property funds.

Institutional investors sold commercial property for the third consecutive quarter in Q2 2016 acquiring property assets worth £1.66bn but recording sales of £1.83bn. Net disinvestment in Q2 of £171mn compared to net disinvestment of £2.55bn in Q1. In the 12 months to June, net disinvestment by institutions amounted to £3.1bn compared with net investment of £1.6bn in the 12 months to March.

In the second quarter, **pension funds** invested a further £186mn compared to a net investment of £119mn in Q1. Total investment by pension funds in the 12 months to June amounted to £203mn compared to £265mn in the 12 months to March and £683mn in the year to June 2015. **Life companies** sold property for the third quarter in succession. Net disinvestment in Q2 amounted to £484mn compared to net disinvestment of £32mn in Q1. Total disinvestment in the 12 months to the end of March amounted to £1.3bn compared to £686mn in the 12 months ending March and net investment of £1.4bn in the year to June 2015. **Property Unit Trusts** invested £103mn in Q2 compared to disinvestment of £2.6bn in Q1. Net disinvestment in the 12 months to the end of June amounted to £2.1bn compared with net disinvestment of £1.4bn in the 12 months ending March and investment of £2.4bn in the year to June 2015 (National Statistics, 2016).

In Q3 2016 total investment in UK commercial property by all domestic and overseas investors decreased by 36% to £7.7bn from £12.0bn in Q2.

Investment in Central London offices in Q3 decreased by 48% to £1.8bn from £3.5bn in Q2. This key market segment made up 24% of all transactions in Q3 compared to 29% in Q2. Investment also decreased across all other segments in Q3 compared to Q2. (Property Data, 2016)

Investment by UK institutions and property companies decreased by 46% in Q3 to £3.8bn from £7.0bn in Q2. Money into commercial property from overseas investors decreased by 22% to £3.9bn from £5.0bn in Q2 and overseas investors share of the UK investment market increased to 50% from 41% in Q2. (Property Data, 2016)

The largest deals of Q3 were portfolio sales comprising Car Parks, M&S stores and Student Accommodation. In London British Land sold Debenhams' Oxford Street store to a Swedish investor. The largest single asset transaction outside London was Deka's acquisition of 1 St. Peters Square, Manchester.

Total institutional investment turned positive in Q2 but investors continued to reduce their exposure to risky assets ahead of the Brexit vote. Net investment amounted to £6.3bn compared to net disinvestment in Q1 of £18.8bn. Institutions made net investments in Q2 of £11.9bn in cash and other short-term instruments and £12.7bn in UK gilts, but sold out of UK and Overseas equities. (National Statistics, 2016)

Business rates

In April 2017 business rates will be based on the first revaluation for seven years.

Business rates are based on a property's rateable value (RV) This is currently its open market rental value on 1 April 2008, based on an estimate by the Valuation Office Agency. With effect form 1st April 2017, following a revaluation, the RV will be based on 2015 rental values. Much has happened in the intervening years to both the economy and the commercial property market.

In the wake of the global banking crisis, the UK economy suffered the worst recession since the 1930's Depression and the slowest recovery since the end of the First World War. Even today some regions and strategic parts of the economy have still not recovered their pre-recession levels.

After suffering a sharp downturn, London was the first of the UK's regions to recover. It's strong growth since 2010 has benefitted the neighbouring South East and East of England but the recovery of the Midlands and Northern economies has been lacklustre.

Since the peak of the last economic cycle in 2007, every region of the UK has under-performed the UK average with the exceptions of London and the South East. Economic output in Yorkshire and Humberside is still below its 2007 level.

The fastest growing city economies have been Guildford, Cambridge, Reading, Bristol and Manchester. Birmingham's economy is just 1% larger than it was in 2007. But the economies of Leeds, Liverpool and Sheffield remain smaller than they were in 2007.

The dominant service sector was the first part of the economy to recover. Manufacturing and construction, however, have struggled to regain the output lost in 2008 and 2009. Manufacturing is still 4.7% below its pre-recession level, construction is just 0.2% higher, however, the service sector is 11.3% higher.

Internet shopping from desktops, laptops and handheld devices now accounts for 14% of all shopping. Some retailers who were slow to adapt to

Investment in UK Property
Q2 2016 (£m)

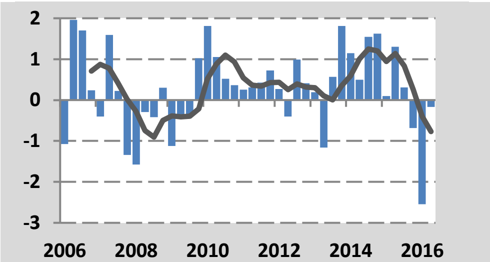
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	625	830	204	1,659
Sell	439	1,295	96	1,830
Net	186	-465	108	-171

Source: National Statistics

Net Institutional Investment (£bn) Q2 2016
By asset type

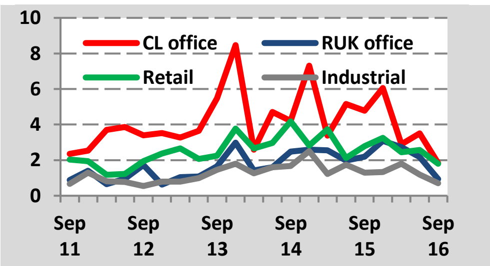
Source: National Statistics

Net Institutional Investment in Property (£bn)



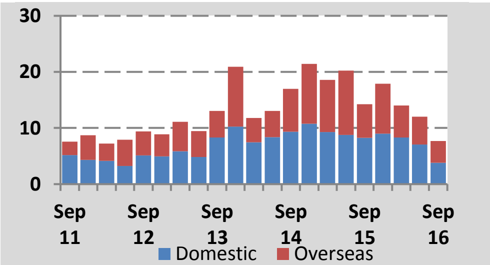
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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the new retail landscape are no longer trading. Across the UK vacancy rates are high and alternative uses have yet to be found for shops peripheral to town centres. Shops, Retail Warehouses and Shopping Centres have all suffered from on-line competition. More particularly, while retailing in Central London and across the UK's regional centres has thrived since 2008, retailing in many sub-regional centres and market towns has struggled.

To fulfill the ever-increasing web orders, retailers and logistics operators have expanded their distribution operations. Since 2008 demand for large high bay national and regional distribution warehouses together with smaller local facilities on the edge of conurbations has grown strongly

These macro-economic trends have been reflected in the UK's commercial property market. Retail rents have largely stagnated. City of London and West End offices now command rents greater than those prevailing before the onset of the Great Recession. Office rents have also reached new highs in Birmingham, Manchester, Bristol and Leeds. Demand from occupiers and investors has driven the development of new "sheds" especially in the regional hubs and near centres of population.

Table 1; Estimated %'age change in NNDR (National Non-Domestic Rates) liability
(excluding all reliefs and supplements)

	Retail	Office	Industrial
London			
City of London	8%	25%	20%
West End	53%	5%	-4%
Brent	8%	11%	-3%
Hillingdon	-4%	19%	-3%
Hounslow	4%	66%	-5%
South East			
Cambridge	-8%	12%	-2%
Guildford	2%	13%	-6%
Oxford	-2%	-8%	2%
Reading	-4%	46%	-6%
Wokingham	-1%	33%	3%
Rest of UK			
Birmingham	0%	-15%	-3%
Bradford	-9%	-17%	-3%
Bristol	-9%	-5%	4%
Cardiff	-15%	-17%	-9%
Leeds	-6%	-22%	-1%
Leicester	9%	16%	-2%
Liverpool	-5%	-15%	-8%
Manchester	0%	-2%	-5%
Sheffield	-7%	-20%	-6%

Consequently, the 2017 rating revaluation has seen RVs across all property sectors in England increase by 9.6% but decrease by 2.9% in Wales. In London RVs grew by 23.7%. The revaluation also reflects the economic strength of the South East here values grew by 9.6%. However, across the North West and Yorkshire there was no overall increase in values and in the North East values in the 2017 rating list are -0.9% lower than the 2010 list.

The business rates payable by each occupier are a factor of the RV and the uniform business rate or multiplier. The multiplier for 2016/17 is 49.7%. The multiplier is usually increased each April in line with the annual RPI as at the previous September. In previous revaluation years such as 2010 and 2005, however, the multiplier was adjusted so that average bills increased at the point of revaluation in line with RPI inflation. The 2017/18 multiplier has yet to be announced but indications from Government are that it may reduce to 48.0%. The overall net effects of these changes are shown in Table 1 for various key centres.

The Government has also yet to announce the transitional arrangements but has published two options for consultation.

In the first year of the proposed transition arrangements, large occupiers with a RV greater than £100,000 will have a 4% collar applied to any downward adjustment to their business rate liability whereas the cap on any upwards adjustment will be between 33% and 45%. A small occupier with an RV less than £28,000 in London and £20,000 in the rest of the UK will have a 20% collar applied to any downward adjustment to their business rate liability and a 5% cap on any upwards adjustment.

It is clear that the impact if not the intention will be to tilt the burden of the tax towards large occupiers in London and the South East (see table 2) which are best placed to pay bearing in mind the nature of the economic recovery.

The implications of the 2017 re-valuation for the investment performance of commercial property in England & Wales are uncertain. Rationally it might be expected that a sharp and uncontrollable increase in the business rate would lead to a decrease in rental values and vice versa. But occupational costs in the form of rents, rates and service charges are not a zero sum game.

Some occupiers demand to be in a particular location almost regardless of cost. Luxury goods retailers in Bond Street are prepared to pay £2,500 per sq. ft. Zone A as a marketing tool and to have a presence on one of the most chic pieces of real estate in Western Europe. Hedge fund managers are prepared to pay £140 per sq. ft. for office space in St James's and the City of London is a magnet for insurance companies, banks, asset managers and many others.

Furthermore, the impact of an increase in business rates on the overheads of a business will vary from organization to organization. For many real estate costs are limited compared to personnel costs.

It is impossible to draw any lessons from the previous revaluation in 2010 due to the background noise of the Great Recession. Likewise it may be difficult to draw any conclusions regarding the impact of the 2017 re-valuation if the uncertainties caused by Brexit result in weaker macro-economic growth, a loss of London's passporting rights and a structural dislocation of Central London's commercial property market.

Table 2; Locations with an average RV of £100,000+

	Average RV
Retail	
West End	£186,000
Kensington and Chelsea	£124,000
Dartford / Bluewater	£105,000
City of London	£96,000
Office	
City of London	£182,000
West End	£147,000
Docklands	£141,000
Midtown	£132,000
Southbank	£111,000
Industrial	
Slough	£96,000

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